

EMPLOYEE STOCK OPTION PLANS

HEARING
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
OF THE
COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES
ONE HUNDRED SIXTH CONGRESS
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EMPLOYEE STOCK OPTION PLANS

THURSDAY, OCTOBER 12, 2000

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:30 a.m., in room 1100, Longworth House Office Building, Hon. Amo Houghton, (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE

CONTACT: (202) 225-7601

October 5, 2000

No. OV-24

Houghton Announces Hearing on Employee Stock Option Plans

Congressman Amo Houghton (R-NY), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing to examine the Federal tax treatment of employee stock option plans under current law. The hearing will take place on Thursday, October 12, 2000, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:30 a.m.

Oral testimony at this hearing will be from invited witnesses only. Invited witnesses include representatives from the U.S. Department of the Treasury and the private sector, including representatives from trade organizations and benefit groups. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

Businesses generally can offer their employees one of three types of stock option plans: (1) non-qualified stock options, (2) incentive stock options, and (3) employee stock purchase plans. Each type of stock option is treated differently under the Internal Revenue Code (I.R.C.).

Non-qualified stock options are the most utilized form, and their tax treatment is found in section 83 of the I.R.C. Typically, non-qualified options are granted by businesses to a set of employees on a date certain and must be exercised within a certain time limit. For publicly-traded companies, the price at which employees may purchase the options (the grant price) is generally the value of the stock at the close of the markets on the day that the options are granted. There are no tax consequences to either the employee or the business at the time of grant. When the employee exercises an option, he or she recognizes ordinary income on the difference between the value of the stock when exercised and the grant price. Income and employment taxes must be withheld. The employer is entitled to a deduction equal to the amount of ordinary income recognized by the employee. If the employee holds the stock for 12 months after the day he or she exercises the options before selling, he or she recognizes long-term capital gain on the difference between the sale price and the exercise price.

A company may offer an unlimited amount of non-qualified options to its employees (subject only to shareholder approval). The company may offer non-qualified options only to its officers or to all of its employees; there are no tax or Employee Retirement Income Security Act (ERISA) requirements limiting the amount of options that may be granted to highly compensated employees vis-a-vis rank and file employees.

The tax treatment of incentive stock options is found in section 422 of the I.R.C. Generally, incentive stock options may only be granted at a price, not less than the

fair market value, on the day they are granted. The maximum value that may vest for the first time in any given year is \$100,000 based on the value of the option on date the options are granted. Incentive options must also be exercised within 10 years of the date they are granted. There are no tax consequences to either the employee or the business when the options are granted. When the employee exercises the options, he or she does not recognize ordinary income but may be subject to the alternative minimum tax. If the employee holds the stock for longer than two years from the day the options are granted and more than one year from the day he or she exercises the options, he or she recognizes long-term capital gain on the difference between sale price and grant price. If the holding requirements are met, the company does not receive a deduction. If the holding requirements are not met, incentive stock options are treated as non-qualified options, and the employee generally recognizes ordinary income on the difference between the fair market value of the stock on the day of exercise and the price at which the options were granted. No withholding is required for disqualifying dispositions. In such circumstances, the company would receive a deduction equal to the ordinary income recognized by the employee.

A company may offer incentive stock options to its officers or to all of its employees; there are no tax or ERISA requirements limiting the amount of options that may be granted to highly compensated employees vis-a-vis rank and file employees.

The tax treatment of employee stock purchase plans is found in section 423 of the I.R.C. Employee stock purchase plans differ from non-qualified options and incentive stock options in that they must be offered to all employees. Typically, employees are allowed to contribute a percentage of their income (up to \$25,000 per year), via a payroll deduction, toward the purchase of company stock. For example, an employee may contribute 10 percent of his income toward the purchase of company stock from January 1 through June 30 of a given year. On June 30, the amount contributed would be used to purchase stock (the exercise of the option) at a price set under the plan. The plan may allow the employee to purchase the stock at the price of the stock at closing of June 30, or, as many plans do, the plan may allow the employee to purchase the stock at the lower of the prices on January 1 and June 30. Plans may grant employees a discount of up to 15 percent below the price of the stock. Similar to incentive stock options, there are no tax consequences when an employee exercises the option for either the employee or the company. If the employee holds the stock for two years after the day they are granted and one year after he or she exercises the options, he or she will recognize ordinary income on the 15 percent discount but long-term capital gain on the appreciation of the stock. The company receives no deduction under these circumstances. If the employee does not meet the holding requirements, he or she recognizes ordinary income on the discount and short term capital gain on the remaining amount. In this instance, the company does receive a deduction. No income or employment tax withholding is currently required for either the discount or for disqualifying dispositions.

In announcing the hearing, Chairman Houghton stated: "Stock option plans help employees become stakeholders in their companies, which leads to an increase in productivity and a sense of ownership within the business. We need to make sure the law offers attractive incentives for employers to offer stock option plans to all of their employees."

FOCUS OF THE HEARING:

The focus of the hearing is to examine the Federal tax treatment of stock option plans under current law and proposals to strengthen incentives for employers to offer such plans.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect or MS Word format, with their name, address, and hearing date noted on a label, by the close of business, Thursday, October 26, 2000, to A.L. Singleton, Chief of Staff, Committee on

Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, by close of business the day before the hearing.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be submitted on an IBM compatible 3.5-inch diskette in WordPerfect or MS Word format, typed in single space and may not exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers where the witness or the designated representative may be reached. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press, and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at "<http://waysandmeans.house.gov>."

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202-225-1721 or 202-226-3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman HOUGHTON. Good morning everybody. The hearing will come to order. We are delighted to have you here as a panel, and we want to welcome you. We are here to discuss, as you all know, the employee stock option plans. Promoting stock options may sound far removed from the everyday concerns of working men and women, but nothing could be further from the truth.

Employee-owned stock holds the promise of transforming our free enterprise system. Two important features of the Federal Tax Code provided a tremendous security to middle-income Americans during the 20th century. First, the deductibility of mortgage interest transformed a nation of renters into a nation of homeowners; and secondly, tax incentives for employer-sponsored pensions and for retirement savings have made it possible for millions of working people to be secure in their retirement years.

So, think for a moment how different our country would be if we didn't have these incentives in our tax system. At the beginning of the 21st century, I believe employee stock options will make it possible for working middle-class, middle-income Americans to become greater stakeholders in our free enterprise system. Someone once said that the problem with socialism is socialists and the problem with capitalism is capitalists.

That may be, but it seems to me that the only problem with the capitalists is that there are not enough of them. Today we are going to look at the tax treatment of stock option plans under current law and what, if anything, needs to be done to strengthen incentives for employers to offer them to a broader base of employees.

Free enterprise is strong in America today because it has offered security to many. It seems obvious to me that the next step in broadening the base of our free enterprise system is to allow for more working men and women to own stock in the companies for which they work. So, I'm pleased to recognize our senior Democrat on our subcommittee, the distinguished Mr. Coyne from Pennsylvania, for an opening statement.

Mr. COYNE. Thank you, Mr. Chairman.

This hearing will provide the Ways and Means Oversight Subcommittee with valuable information about the current tax rules designed to encourage employers to offer employees the opportunity to obtain stock in the companies for which they work. Many hard-working Americans would like to have the chance to become stockholders, not just employees, of the corporations they work for.

The bipartisan legislation proposed by Chairman Houghton deserves our close attention and support. Our tax laws currently provide for various employee stock option arrangements, which will be discussed today. In doing so, it is important that we consider what more can be done to provide employers with incentives to expand the availability of employee stock options and to provide employees with incentives to participate.

I want to commend Chairman Houghton for taking this initiative to introduce the Universal Employee Stock Option Act of 2000. I also want to commend the chairman for the outstanding leadership that he has provided all through this 106th Congress on the Oversight Subcommittee on so many various subjects that we have taken up.

Thank you.

Chairman HOUGHTON. Thanks very much, Bill. I really appreciate that. It has been wonderful working with you and I look forward to doing so. Now, the distinguished gentlemen from Ohio, Mr. Boehner. I am sure you have an opening statement. At least, I hope so.

Mr. BOEHNER. Well, Mr. Chairman, let me commend you for having this hearing today and thank you for the invitation to join your panel. I think when we think about the new economy today, we think in terms of technology. But the more important factor in the new-economy companies is teamwork. American businesses are learning that to compete successfully in the global marketplace, they need to engage the full talents of their workers, their teams, if you will, as never before.

I think they are finding their most important asset is not their physical plant; it is the talent, cohesiveness and work ethic of their entire workforce. That is why team-building is replacing bureaucracy throughout our economy for companies that make sofas in southwestern Virginia, as well as companies that make Internet servers in Silicon Valley.

The new economy is not just about the Internet or technology, rather it is about philosophies and technologies that make the most of the human talent in any company. A critical part of team-building is getting everyone on the same page, making sure that everyone is motivated by common interest. That is the value of stock options, by making the employees a shareholder, stock options also make them valued team members who see their interest and those of the rest of the team as one and the same.

New-economy companies understand this. Stock options are a part of almost any compensation package in the high-tech sector, but increasing numbers of more-established companies also understand the power of stock options and make them widely available to their employees. Those companies range from 3M to Pepsi, to Merrill Lynch and CitiGroup. Unfortunately, for reasons that I think we will hear today, Federal law does not maximize the potential benefit to workers and to employers that stock options can't offer.

I am here today because I share Chairman Houghton's deep commitment to changing that. He and I have introduced separate, but complementary, bills in this Congress to address these obstacles. I think this issue will be a compelling one, certainly for the next Congress. A new economy means new opportunities, and we in Congress should help our constituents embrace those opportunities. Working together, I believe that we will.

Chairman HOUGHTON. Thanks very much, Mr. Boehner.

I would like to call the first panel and I would like to ask Mr. Frederic Cook, of Frederic Cook & Co. in New York, to begin the testimony.

STATEMENT OF FREDERIC W. COOK, CHAIRMAN, FREDERIC W. COOK & CO., NEW YORK, NEW YORK

Mr. COOK. Thank you, Mr. Chairman, Mr. Coyne, Mr. Boehner. It is a pleasure to be here today. My name is Fred Cook. I represent the firm of Frederick W. Cook & Co., which is a management compensation consulting firm. For 30 years, our firm and a predecessor firm have advised corporations on the design and administration of employee stock ownership and stock option plans.

We are strong advocates of such plans and the sharing of ownership and wealth-creation opportunities broadly in the corporation because we believe that benefits our economy as a whole. Do the members have my charts that are accompanied by testimony, because I plan to speak from them?

Chairman HOUGHTON. I think we do.

Mr. COOK. All right. On page one, I give a brief summary of the current tax situation, which I will not go into detail because it has been written up ably by the committee materials in advance. I would merely point out that, of the three types of plans available to employee stock options, please note that one of the major advan-

tages of tax qualification is there is no tax at exercise. Tax is deferred until sale, at which time there is long-term capital gains tax on the appreciation above the value at grant if the holding period requirements are met.

That has been fundamental in tax legislation on stock option since the 1950s. In exchange for that, on the two tax qualified plans, employee stock purchase plans and incentive stock options, the corporation forgoes its tax deduction. That is the balance of the tax equation between employees and corporations that was put in place with the Revenue Act of 1950 and with minor modifications remains in place today.

Let me next go to a quick summary of incentive stock options under Code section 422 on chart two. The basic things to have you focus on here, if I may, are that the employee exercises the option with after-tax money; that is line one. In line six, there is, as I mentioned earlier, no tax at exercise; however, the gain at exercise is subject to the alternate minimum tax as an item of tax preference. On line seven, to reiterate, there is no corporate tax deduction at exercise or at sale of the stock when capital gains applies to the employees.

My comments here are that the imposition of the alternate minimum tax discourages holding of the stock, and the lack of corporate tax deduction is regarded by most corporations as financially inefficient. Please note here that in giving capital gains to employees versus ordinary income and thereby letting employees obtain the tax differential between capital gains and ordinary income, the corporation is giving up its full tax deduction, which it otherwise obtains in non-qualified plans.

So, to provide an incremental benefit to employees, the corporation forgoes its full tax deduction in qualified plans. That is what I mean by tax inefficiency on the corporate side—and discourages the use of incentive stock options for key employees. My comments and suggestions for consideration in tax legislation are on chart three.

The basic ideas that I would present for the subcommittee's consideration are that in line four, we consider encouraging companies to spread the use of incentive stock options by imposing a requirement that at least half of the shares granted in any year go to non-highly-compensated employees, as defined under Code Section 401.

With that in place, we would not really need the \$100,000 maximum annual vesting limit that is in line five. I would continue to exclude employee taxation at gain and would suggest that the committee amend the Code so that the gain at exercise of incentive stock option is no longer deemed an item of tax preference income subject to the alternate minimum tax.

The employee taxation at sale, line eight, I would suggest that the gain at exercise be ordinary income, rather than capital gain and, in exchange for that, the company would be allowed to deduct the same amount at exercise that the employee is taxed as ordinary income when the stock is sold. That is a timing difference, but is otherwise a matching of deduction and personal income tax.

I see that I have run close to being out of time. In summary, I would say that the tax compact set in the Revenue Act of 1950 was

that the employee would get capital gains only at sale and the corporation would forego a tax deduction.

For the next 50 years, I would suggest that we change that tax compact. We would continue to allow no taxation at exercise of the option for the employee; the employee would only be taxed at sale. We would permit the corporation to obtain a tax deduction at exercise, which would remove the financial inefficiency. And in exchange for that, the employee, when he is subject to tax, would pay ordinary income on the value at exercise and capital gains on the remainder.

We would continue to strongly encourage companies through tax law to extend the benefits of stock options broadly throughout their organization. The purpose of this is to address the growing wage gap between the top and the bottom. Stock options are predominantly responsible for the rising wage gap between the top and the bottom. Instead of clamping down or placing limits on the top, the better way is to raise up the bottom. And raising the bottom should be done through encouraging employees through pre-tax compensation to become long-term stockholders of their company through stock options.

Thank you Mr. Chairman, members.

[The prepared statement follows:]

Statement of Frederic W. Cook, Chairman, Frederic W. Cook & Co., New York, New York

Mr. Chairman, Mr. Coyne, members of the Subcommittee and Mr. Boehner, it is a pleasure to be here today. My name is Fred Cook. I represent the firm of Frederic W. Cook & Co., which is management compensation consulting firm. For 30 years, our firm and a predecessor firm have advised corporations on the design and administration of employee stock ownership and stock option plans. We are strong advocates of such plans and the sharing of ownership and wealth-creation opportunities broadly in the corporation because we believe that benefits our economy as a whole.

My testimony today will refer to the charts which I believe are in your folders and available at the back of the room.

Current Situation (Chart 1)

Under current tax laws affecting tax-qualified options (IRC § 422 and 423), employee contributions are made with after-tax dollars and, if certain requirements are met, the employees does not incur tax on gains at exercise and may claim long-term capital gains treatment at sale if minimum holding period requirements are met. The price for this favored treatment is the loss of a corporate tax deduction. Many regard these plans as financially inefficient for that reason. This has led to the growth of "non-qualified" stock option plans and also to the popularity of 401(k) plans which permit employee contributions with pre-tax dollars.

Incentive Stock Option Situation (Chart 2)

Use of Incentive Stock Options ("ISOs"), tax-favored under IRC § 422, is a declining practice. Many companies prefer non-qualified options ("NSOs") for their key employees. The reasons are that (1) ISO gains at exercise are subject to the Alternative Minimum Tax which encourages selling the stock in the year of exercise to avoid this onerous and unfair tax, and (2) corporations receive no tax deduction for the option gain at exercise. Many regard ISOs as financially inefficient because they are giving up a full tax deduction to provide only an incremental benefit to employees (i.e., the tax savings between an ordinary income rate and the long-term capital gains rate).

Incentive Stock Option Proposal (Chart 3)

Our proposals for changes in tax law to improve the effectiveness of ISOs are to exclude the gain at exercise from the alternative minimum tax, allow the employer a tax deduction equal to the gain at exercise, and get this back by taxing the employee when the shares are sold at ordinary tax rates on the gain at exercise, with excess gains treated as a capital gain. We advocate dropping the \$100,000 annual

vesting limit currently in ISOs, and substituting a requirement that at least half the shares granted as tax-qualified options each year (including IRC § 423 shares) would need to be granted to “non-highly compensated employees” as defined under IRC § 414(q). This will insure that the ISO benefits don’t just go to top management.

Employee Stock Purchase Plan Situation (Chart 4)

Tax-qualified employee stock purchase plans also have been declining in popularity except in the high-tech sector. The reasons seem to be that (1) employee payroll deductions are in after-tax dollars which places these plans at a disadvantage versus IRC § 401(k) plans, and (2) the same financial inefficiency that affects ISOs exists with these plans as well, namely no tax deduction for option gains at exercise.

Employee Stock Purchase Plan Proposal (Chart 5)

We support the provision in Congressman Houghton’s bill (HR 4972) that employee contributions to IRC § 423 employee stock purchase plans (“ESPPs”) should be permitted with pre-tax dollars. As under present law, there should be no employee tax at exercise. Employees should be taxed only at sale of the stock, with ordinary income tax due based on the stock’s value at exercise, and capital gains tax on any excess gain realized. Corporations should be allowed a tax deduction at exercise for the same amount taxable as ordinary income to the employee at sale. There should be no alternate tax or employment taxes imposed on amounts treated as ordinary income. ISO and ESPP taxation would be identical, thereby simplifying the Internal Revenue Code.

For ESPPs, we advocate foregoing the 85 percent of market value option price and the “look-back” feature in exchange for pre-tax employee contributions and a corporate tax deduction at exercise. We believe the 85 percent pricing feature, while nice, is not necessary to encourage participation. And, like many, we believe the 85 percent “look-back” feature is unfair to shareholders and encourages employees to “flip” the stock at exercise for ordinary income.

ESPPs should retain the requirement that essentially all full-time U.S. employees would be eligible to participate, except that bargaining unit employees could be excluded, just like under 401(k) plans. These changes, taken together, would put ESPP on an even keel with 401(k) plans and be very positively received by companies and employees alike.

Summary Proposal (Chart 6)

The present tax situation with respect to tax-favored employee stock option and purchase plans was put in place fifty years ago in the Revenue Act of 1950, and has been essentially unchanged since. Specifically, in exchange for no tax to employees at exercise and long-term capital gains at sale, companies are not allowed a tax deduction for option gains. This should be changed for the twenty-first century. Employers should be encouraged to adopt tax-qualified plans by being able to deduct gains at exercise, now only available under non-qualified plans and through disqualifying dispositions under tax-qualified plans. Employees should be encouraged to participate in ESPPs by permitting payroll deductions with pre-tax dollars. And employees should be encouraged to hold stock for the long run by deferring tax from option exercise to stock sale and by eliminating gains at exercise from being subject to employment taxes and the alternate minimum tax.

The purpose of these changes is to address the growing wage gap between the top and the bottom. Stock options are predominantly responsible for rising pay at the top. Instead of clamping down or placing limits on the top, the better way is to raise up the bottom. And raising the bottom should be done through encouraging employees to become long-term shareholders of their company through stock options.

Thank you for your attention to this important matter.

A. CURRENT SITUATION

	Design Limits	Employee Taxation			Corporate Deduction		
		At Grant	At Exercise	At Sale	At Exercise	At Sale	Employment Taxes on Gain
Non-Qualified Options (NQOs)— IRC § 83.	None	None	Ordinary Income	Capital gain/loss on excess	Yes	No	Yes
Incentive Stock Options (ISOs)— IRC § 422.	—100% FMV —10 yr. term —\$100,000 vesting limit/yr.	None	None, except gain is subject to AMT.	Capital gains on full gain	No	No	No
Employee Stock Purchase Plans—IRC § 423.	—All ees. eligible —Uniform terms and oppor- tunity —100% FMV/5 yrs. —85% FMV/27 mos. —\$25,000 mkt. value/yr.	None	None	15% discount is ordinary in- come; rest of gain is capital gain.	No	No	No

B. INCENTIVE STOCK OPTIONS (ISOs)

	Current Provision	Comment
1. Employee Exercise Funds	After tax	Accepted practice
2. Minimum Option price	100% FMV	Accepted practice
3. Maximum Option Term	10 years	Accepted practice
4. Anti-discrimination Re- quirements.	None.	
5. Individual Limits	\$100,000 grant value vest- ing per year.	
6. Employee Taxation at Ex- ercise.	None; gain subject to AMT ..	AMT applicability encourages early sale
7. Co Deduction at Exercise	None	Discourages use; financially inefficient
8. Employee Taxation at Sale	Capital gains.	
9. Employment Taxes	None.	

B. INCENTIVE STOCK OPTIONS (ISOs)

	Current Provision	Proposed Change
1. Employee Exercise Funds	After tax	None
2. Minimum Option price	100% FMV	None
3. Maximum Option Term	10 years	None
4. Anti-discrimination Re- quirements.	None	50% or more shares granted per year go to Non-Highly Compensated Employees
5. Individual Limits	\$100,000 grant value vest- ing per year.	Drop; #4 change above is better
6. Employee Taxation at Ex- ercise.	None; gain subject to AMT ..	Exclude gain from AMT
7. Co Deduction at Exercise	None	Gain at exercise deductible
8. Employee Taxation at Sale	Capital gains	Gain at exercise is ordinary income; excess is capital gain
9. Employment Taxes	None	None

C. EMPLOYEE STOCK PURCHASE PLANS (ESPPs)

	Current Provision	Comment
1. Employee Payroll Deductions.	After-tax	ESPPs disadvantaged vis-à-vis 401(k) plans
2. Minimum Option price	85% FMV at start or end of period.	“Look-back” feature encourages stock “flipping”
3. Maximum Option Term	27 mos. if 85% FMV price; 5 yrs. if 100% FMV price.	Not a problem in practice
4. Anti-discrimination Requirements.	Essentially all employees must be eligible.	More stringent than § 401 rules; discourages use in cos. with unions
5. Individual Limits	\$25,000 grant value/yr.	Most sign up for far less
6. Employee Taxation at Exercise.	None.	
7. Co. Deduction at Exercise	None	Discourages use; financially inefficient
8. Employee Taxation at Sale	15% discount is ordinary income; rest of gain is capital gain.	
9. Employment Taxes	None.	

C. EMPLOYEE STOCK PURCHASE PLANS (ESPPs)

	Current Provision	Proposed Change
1. Employee Payroll Deductions.	After-tax	Pre-Tax
2. Minimum Option price	85% FMV at start or end of period.	100% FMV at grant
3. Maximum Option Term	27 mos. if 85% FMV price; 5 yrs. if 100% FMV price.	5 years
4. Anti-discrimination Requirements.	Essentially all employees must be eligible.	Permit cos. to exclude bargaining unit employees
5. Individual Limits	\$25,000 grant value/yr.	\$10,000/yr., indexed
6. Employee Taxation at Exercise.	None	None
7. Co. Deduction at Exercise	None	Stock value at exercise deductible
8. Employee Taxation at Sale	15% discount is ordinary income; rest of gain is capital gain.	Stock value at exercise is ordinary income; excess is capital gain
9. Employment Taxes	None	None

D. PROPOSED SITUATION

	Design Limits	Employee Taxation			Corporate Deduction		
		At Grant	At Exercise	At Sale	At Exercise	At Sale	Employment Taxes on Gain
Non-Qualified Options (NQOs)— IRC § 83.	None	None	Ordinary Income	Capital gain/loss on excess	Yes	No	Yes
Incentive Stock Options (ISOs)— IRC § 422 —100% FMV.	—10 yr. term —\$100,000 vesting limit/yr.	None	None, no AMT	Gain at exercise is ordinary income; excess is capital gain.	Gain at exercise is deductible.	No	No
Employee Stock Purchase Plans—IRC § 423.	—All ees. eligible except union —Uniform terms and opportunity —100% FMV/5 yrs. —\$10,000 mkt. value/yr. pre-tax	None	None	Stock value at exercise is ordinary income; excess is capital gain.	Stock value at exercise is deductible.	No	No

Chairman HOUGHTON. Thanks very much, Mr. Cook.
Mr. Capuano, Senior Vice President of Corporate Development,
Proxicom, in Reston.

**STATEMENT OF CHRISTOPHER CAPUANO, SENIOR VICE
PRESIDENT, CORPORATE DEVELOPMENT, PROXICOM, INC.,
RESTON, VIRGINIA**

Mr. CAPUANO. Thank you very much, Mr. Chairman, for inviting me to appear today. My name is Chris Capuano and I am the Senior Vice President for Corporate Development for Proxicom, Inc. Proxicom, a Reston-based company, is the leading e-business consulting and development company that delivers Internet and wireless solutions for Fortune 500 companies.

When I joined Proxicom in 1996, we were a small company of about 40 employees with a vision around the Internet. That was the year we implemented our broad-based stock option plan covering all employees. Today we are a profitable firm of approximately 1,300 employees, publicly traded, with offices around the United States and Europe.

In a start-up company, all employees wear multiple hats; and one of the hats I wore when I joined Proxicom was as the creator of the Proxicom stock option plan. In designing the plan, our philosophy was very simple: Each and every employee is critical to the success of the company. Stock options, therefore, were and still are provided to each and every employee to align all of us with the success of the company and to share in the growth.

From the receptionist who first greets our clients to the technical consultants to our project managers, all employees receive stock options. When the employee vests in the stock option, the employee may exercise the option and buy the underlying stock. As you know, on exercise of the option, our employees must also pay tax on the difference between the option price and the market value of the Proxicom stock, even if the employee has not sold any shares or actually pocketed any cash gain.

It is a tax on the paper profit only. Many of our employees are forced to sell some of their Proxicom stock to pay this tax. Other employees who wish to hold onto their shares are forced to take loans. While we typically grant incentive or qualified stock options, which would normally defer tax payment, many of the options granted today are non-qualified stock options due to the tax code's quantitative limits on our ability to provide ISO's.

In any event, the impact of the alternative minimum tax negates the benefit of the incentive stock options for many of our employees by taxing again the paper gain before any stock is actually sold. Many of our employees are therefore again forced to sell shares and thereby forego a stake in our long-term growth to pay off the AMT.

At Proxicom, our broad-based employee stock plans offer strategic benefits. The plans improve corporate productivity and profitability by helping to align employee and shareholder interests while providing a tangible and very visible tool to attract, inspire

and retain our employees, something that is especially important in today's tight labor market.

With many Proxicom employees coming from firms not offering stock plans, our ability to directly reward our employees based upon our overall success is key to our continued growth. From an alignment perspective, our stock option plan is a major component in threading together our shareholders, our corporate strategy and the individual desires of every employee.

In a growing business like Proxicom, where resources are very tightly managed, share ownership through stock plans keeps our employees focused on teamwork, productivity and quality through the sharing of resources, best practices and knowledge. With our stock plans, our employees also fully appreciate the importance of both the short-term or quarterly results and the long-term. This understanding clearly drives our growth.

The Proxicom stock plans also provide significant opportunity for individual employee financial gain. Many of our top recruits forego larger cash-based pay packages to have the opportunity to share in the overall success of the company over the long-term. This translates into an opportunity for long-term financial savings and stability for our employees.

In our opinion, the provisions of the Wealth to Workplace Act will greatly enhance the effectiveness of stock option plans like the Proxicom stock option plan by enabling our employees at all levels to continue to hold on to their company's stock after exercise, rather than selling the shares to pay the tax due. With this important provision, our employees will not be forced to give up the opportunity for long-term appreciation in our stock and Proxicom will grow stronger by having more dedicated, long-term employee shareholders.

I also note for your consideration that the alternative minimum tax has a broad negative impact at Proxicom, depriving many of our employees of the tax deferral benefits of the qualified stock options. Proxicom also applauds the efforts behind the Universal Employee Stock Option Act. Because at Proxicom we fully appreciate the benefits of broad-based employee stock ownership, we can foresee implementing such a plan for our employees in addition to our current stock programs.

In general, in our opinion, the more tools that are at our disposal to increase broad-based employee stock ownership, the better. In conclusion, the broad-based provision of stock options for Proxicom employees reflect and reinforce the entrepreneurial beginnings, spirit and culture of our company. The employee culture is one of teamwork and common goals, driving to the success of the overall business. This was true for Proxicom as a start-up and it is especially true for us today as a maturing organization.

The Proxicom stock plans are very important tools in establishing and maintaining this culture. They serve as a very visible means for all employees to share in the long-term growth and success of our company.

Thank you.

[The prepared statement follows:]

Statement of Christopher Capuano, Senior Vice President, Corporate Development, Proxicom, Inc., Reston, Virginia

Mr. Chairman and Members of the Subcommittee, thank you for inviting me to join you today to present testimony on the Federal tax treatment of employee stock option plans under current law and proposals, such as the Wealth Through the Workplace Act and the Universal Employee Stock Option Act of 2000, that are aimed at amending such law. It is a pleasure to be here.

My name is Christopher Capuano, and I am the Senior Vice President for Corporate Development for Proxicom, Inc.

Proxicom, based in Reston, Virginia, is a leading e-business consulting and development company that delivers innovative Internet and wireless solutions for Fortune 500 companies and other global, forward-thinking businesses. Our strategy, creative and technology professionals provide specialized e-business development expertise across a number of industries including Automotive, Financial Services, Energy, Media and Telecommunications.

Proxicom has developed and built internet-based solutions for such blue-chip companies as America Online, General Electric, General Motors, Merrill Lynch, Marriott International and NBC, among many others.

Raul Fernandez, our entrepreneur-founder and Chief Executive Officer, started Proxicom in 1991 with \$40,000 he had saved originally to purchase a home. When I joined Proxicom in 1996 we were a small, high-energy company of about 40 employees with a vision about the Internet. That was the year we implemented our broad-based stock option plan covering all employees. Today, we are a profitable firm of approximately 1,300 employees that is publicly traded on NASDAQ ("PXCM"), with offices across the United States and Europe.

As Senior Vice President for Corporate Development, I am responsible for management of our employee stock plans, as well as business development, mergers and acquisitions, and international expansion. Over the course of my service with Proxicom I have also served as the General Counsel and a member of the Board of Directors.

Prior to my joining Proxicom I was a lawyer in private practice, a consultant at Price Waterhouse, and an Adjunct Professor of Law at Georgetown University Law Center, teaching a course on taxation and compensation issues.

On behalf of Proxicom, I would like to thank the Subcommittee for holding this important hearing. These are important issues that will play a critical role in growing businesses and helping employees realize the benefits available from company ownership through employee stock plans.

Stock Options at Proxicom

In a start-up company, all employees wear multiple hats. One of the many hats I wore when I joined Proxicom was as creator of the Proxicom Stock Option Plan and later the Proxicom Employee Stock Purchase Plan. In designing the plans, our philosophy was very simple: each and every employee is critical to the success of the company. Stock options, therefore, were and still are provided to each and every employee to align all of us with the success of the company, and share in the growth. From the receptionist who first greets our clients, to our technical consultants, to the project managers, all employees receive stock options.

Under our stock option plan, an employee receives a stock option on his/her starting date with the company. The option vests, or becomes exercisable, over 4 years; the option itself has a life of 10 years so that as long as you remain an employee, you have 10 years to exercise the option. The focus is on the long term.

The price of the option is the fair market value of the stock when the individual joins the company. When we were a private company, we calculated the price based on the value of the business at various points in time, typically when we took in venture capital. As a public company it is very simply determined as the closing price of our stock on the day before the grant date.

Proxicom employees also receive additional stock option grants every year they are with the company. These refresh grants also vest over the four years following the date of the refresh grant, thereby continuing to provide long term growth opportunities to our employees.

When the employee vests in the stock option (for example, after the first year of employment), the employee may exercise the option and buy the underlying stock. As you know, on exercise of the option, our employees must also pay tax on the difference between the option price and the market value of the Proxicom stock, even if the employee has not sold any shares or actually pocketed any cash gain. It is a profit on paper only. Many of our employees are forced to sell some of their

Proxicom stock to pay this tax; others who wish to hold onto the shares long term are forced to take out loans to pay the tax.

While we offer qualified stock options, which would defer the tax payment, most of the options granted today are nonqualified stock options due to the tax code limits on qualified stock options. In any event, the impact of the alternative minimum tax negates the benefit of qualified stock options for many of our employees by taxing the paper gain before any stock is sold. Again, many of our employees are forced to sell shares, and thereby forego a stake in our long-term growth, or take loans to pay off this tax on their exercised options.

The Proxicom option process is fully internet-enabled, with the stock option plan document and all of the employee's specific option information, from vesting dates, to pricing to taxes, contained on the employee's personal web site and available any time day or night.

Impact of the Proxicom Stock Option Plan

The impact of the Proxicom stock plans on our company and our employees is positive on many fronts. In short, share ownership through our stock plans promotes teamwork and provides a specific incentive for all our employees to understand and grow with our business through the long term. The stock plans bring strategic benefits to Proxicom, financial and personal benefits to employees, and overall contribute to the long-term growth of our company.

Strategic Benefits to Proxicom

At Proxicom, our broad-based employee stock plans offer strategic benefits to Proxicom. The plans improve corporate productivity and profitability by helping to align employee and shareholder interests while providing a tangible and very visible tool to attract, inspire, and retain employees—especially in our tight labor market. With many Proxicom employees coming from firms not offering stock plans, our ability to directly reward our employees based upon our overall success is a key to our continued growth.

From an alignment perspective, our stock option plan is a major component in threading together our shareholders, our corporate strategy, and the individual desires of every employee. In a growing business like Proxicom, where resources are very tightly managed, share ownership through the stock plans keeps our employees focused on teamwork, productivity, and quality through the sharing of resources, best practices, and knowledge. Our employees understand that any other performance would only serve to sub-optimize the whole business.

For example, in addition to their daily responsibilities, Proxicom employees design and deliver thousands of hours of internal training per year to help fellow employees learn and grow their skills as the company grows. Our employees regularly volunteer their free time to identify and implement improvement programs in each office.

As a tool to attract, inspire, and retain employees, it has always been our philosophy that the employees should "act and be treated as owners." The stock plans support this philosophy by providing the opportunity for personal wealth (attraction); rewarding employees for corporate success (inspiration); and encouraging long-term employment, learning, and collaboration (retention). "Owners" focus on improvement, results, the company as a whole and the success of others, instead of their specific piece of the pie.

Benefits to Proxicom Employees

The Proxicom stock plans provide a significant opportunity for individual employee financial gain. Many of our top recruits forego larger cash base pay packages to have the opportunity to share in the overall success of the company over the long term. This translates into an opportunity for long-term financial savings and stability. This ownership link between company and individual success is the cornerstone to our ability to attract, inspire and retain talent while delivering superior results to our clients.

In addition to volunteering for internal projects and working on weekends, it is not uncommon for employees to support non-profit endeavors as a way to help the company succeed. Rather than contribute cash, many of our employees contribute stock purchased through the stock option plans to charitable causes, which, of course, benefits the community as well.

The law as it currently stands erodes the financial benefit of certain stock options and lessens their positive impact for our employees. The current proposals before you, however, would help to restore the value of such options and allow every em-

ployee to fully share in the long-term success of the company at which they choose to work.

Impact on Proxicom's Growth

Because we are a "people business," our broad-based plans aimed at our employees are critical in helping Proxicom grow. Growth is achieved not only by aligning employee and corporate interests and promoting teamwork, but also by offering long-term incentives to employees to deliver quality work over time. With our stock plans in place, our employees understand the importance of short-term (quarterly) and long-term success. This understanding clearly helps to drive our continued growth.

Current law reduces the long-term benefit of certain stock options by forcing our employees, in many cases, to sell stock before they wish to in order to pay taxes. This affects the majority of our employees, and most often the less financially stable employees who cannot not afford to pay the tax unless the shares are sold. The current proposals would help alleviate this need to sell and instead restore the long-term performance incentives and long-term savings benefit of such stock options, thus benefiting both employees and companies on which the strength of the economy is based.

The Proposals

In our opinion, the provisions of the Wealth Through the Workplace Act will greatly enhance the effectiveness of stock plans like the Proxicom Stock Option Plan by enabling our employees at all levels to continue to hold on to their company stock after exercise, rather than selling the shares to pay the tax due on the stock's paper gain. With this important provision, our employees will not be forced to give up the opportunity for long-term appreciation in our stock, and Proxicom will grow stronger by having more dedicated, long-term employee shareholders. Also favorable is the provision preserving the ability of the company to take the deduction. This is a financially sound approach for business that shows long term thinking by this Committee.

I also note for your consideration that the alternative minimum tax has a broad negative impact at Proxicom, depriving many of our employees of the tax deferral benefits of the qualified stock options, thus forcing our employees to sell their stock to pay the tax.

Proxicom also applauds the efforts behind the Universal Employee Stock Option Act of 2000. Because Proxicom fully appreciates the benefits of employee stock ownership, we can foresee implementing such a plan for our employees in addition to the current stock programs offered. In general, the more tools at our disposal to increase employee stock holdings, the better.

Conclusion

The broad based provision of stock options for Proxicom employees reflects and reinforces the entrepreneurial beginnings, spirit and culture of our company. The Proxicom culture is one of teamwork and common goals, driving to the success of the business. This was true for Proxicom as a start up and it is true today for us as a maturing organization. The Proxicom stock plans are very important tools in establishing and maintaining this culture. They serve as a very visible means for all employees to share in the long-term growth and success of the company.

We strongly support the enactment of provisions that will facilitate employee stock ownership and restore the long-term value of such options, thus allowing every employee to fully share in the long-term success of the company at which they choose to work.

Thank you for asking me to join you today. On behalf of Proxicom, I thank you for holding this hearing and I stand ready to answer any questions you might have.

Chairman HOUGHTON. Thanks very much, Mr. Capuano.
Now, Miss Wilma Schopp, the Human Resources Leader, Global Compensation and Benefits at Monsanto.

**STATEMENT OF WILMA SCHOPP, HUMAN RESOURCE LEADER,
GLOBAL COMPENSATION AND BENEFITS, MONSANTO COM-
PANY, ST. LOUIS, MISSOURI, ON BEHALF OF THE AMERICAN
BENEFITS COUNCIL**

Ms. SCHOPP. Good morning and thank you, Mr. Chairman, for the opportunity to appear. I am Wilma Schopp, Human Resource Leader for Global Compensation and Benefits at Monsanto, a subsidiary of Pharmacia Corporation. I am here representing the American Benefits Council, formerly APPWP. I want to thank you, Mr. Chairman, for holding this hearing and for your leadership in creating a positive environment for extending the benefits of stock ownership to American workers, as exemplified by your introduction of the Universal Stock Options Act of 2000.

Broad-based stock ownership programs, which have become increasingly prevalent in the U.S., provide value to both employees and employers. They enable workers to become owners of their companies and provide a significant vehicle of wealth accumulation. Employers value stock option ownership programs as an important recruitment, retention and motivational tool in a competitive labor market.

Moreover, a recent Rutgers University study found that companies with broad-based stock plans have significantly higher productivity levels and growth rates than companies without such plans. At Monsanto, both the company and our employees are firm believers in the benefits of equity ownership. We provide stock options to all of our employees worldwide. We also have an employee stock purchase plan, an employee stock ownership plan and offer Monsanto stock as an investment option in our 401(k) plan.

However, many Americans lack the opportunity to participate in an employer-sponsored stock plan. We believe a top priority for the next Congress should be to build on your efforts, Mr. Chairman, to provide enhanced incentives for broad-based stock plans. Your legislation, H.R. 4972, would provide employers with a significant new incentive to offer stock ownership plans and will encourage employee equity ownership by coupling the power of payroll deduction with increased tax incentives.

Employees would be empowered to hold stock for longer periods, facilitating capital appreciation and a continued ownership stake in the corporation, since shares will be taxed at sale rather than exercise. Moreover, the bill's accelerated deduction for employers will encourage the establishment of new broad-based plans.

We note that legislation introduced by Representative John Boehner, H.R. 3462, contains many of the same positive features.

Mr. Chairman, we hope you will pursue your legislation in the new Congress and continue your efforts to encourage broad-based stock plans. As you do, we offer the following items for your consideration:

We believe that it will be important to clarify that any new stock option or stock purchase design will not displace or lead to adverse consequences for existing arrangements.

While it is appropriate to include coverage requirements in any new stock plan legislation that provides substantial tax advantages, we feel such requirements should be carefully and flexibly

crafted so as not to preclude employers from using the new incentives.

Finally, we recommend that, as with your bill, any legislation establishing a new stock plan design be placed within the Internal Revenue Code, as has been the historical practice.

As you look to future legislative initiatives in this area, we would also ask you to address the following barriers that have the potential to erode employee stock ownership programs even as you seek to expand them. First, we are very concerned about the recent change in position by the IRS that payroll taxes should be imposed whenever options are exercised under a Section 423 employee stock purchase plan.

The IRS has also taken the view that Federal income tax withholding is required on disqualifying dispositions under employee stock purchase plans. Moreover, the IRS had sought to impose these withholding obligations retroactively, despite clear and directly contradictory guidance.

Mr. Chairman, we appreciate your efforts to point out that these new tax obligations will create substantial burdens for employers and will make employees less likely to retain shares after exercise because they will have to sell them to cover the additional tax liability. We are very concerned that the IRS and Treasury are nonetheless poised to issue guidance that could support the imposition of employment tax withholding on employee stock purchase plans and perhaps even incentive stock option transactions.

Because of the counterproductive results of such an approach for employees and employers alike, we believe that legislation will likely be needed to clarify that income and payroll tax withholding obligations do not apply for employee stock purchase plans and incentive stock options.

Second, because the application of the alternative minimum tax to stock option transactions discourages workers from holding company stock, the council strongly supports legislation to exempt the exercise of stock options from the alternative minimum tax.

Third, as provided under H.R. 1102, the pending retirement savings legislation, an employer tax deduction should be allowed for dividends employees reinvest in unleveraged ESOPs, encouraging the accumulation of retirement savings.

Fourth, with many U.S. companies, such as Monsanto, operating overseas, the council urges the Congress to help promote more uniform treatment for employees of U.S. companies by investigating the special problems of offering equity ownership to American employees working in other countries.

I want to thank you, Mr. Chairman, Ranking Member Coyne and the other members of the subcommittee for your interest and dedication to promoting equity ownership by American workers.

[The prepared statement follows:]

Statement of Wilma Schopp, Human Resource Leader, Global Compensation and Benefits, Monsanto Company, St. Louis, Missouri, on Behalf of the American Benefits Council

Good morning and thank you, Mr. Chairman, for the opportunity to appear today. I am Wilma Schopp, Human Resource Leader for Global Compensation and Benefits at Monsanto Company. I am here representing the American Benefits Council (the Council—formerly APPWP), of which Monsanto is a member. The Council is a public policy organization representing principally Fortune 500 companies and other orga-

nizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to employee benefit plans covering more than 100 million Americans.

I want to thank you, Mr. Chairman, for holding these hearings on stock option and other stock benefit plans, and for your leadership in creating a positive environment for extending the benefits of stock ownership to American workers, as exemplified by your introduction of H.R. 4972, the Universal Stock Options Act of 2000. Employee stock option plans are an important part of the benefits package offered by many of our member companies, and we support the goal of expanding these plans. In fact, a recent American Benefits Council survey revealed that a clear majority of our members support providing additional tax incentives for broad-based equity ownership plans.¹ My testimony today will briefly review the national trends in stock ownership, highlight the many advantages of stock plans for employers and employees alike, provide commentary on H.R. 4972, and describe several other pressing stock ownership issues that the Council believes also merit congressional attention. We are pleased to offer our voice on this important policy issue, and we appreciate your consideration of our views.

Stock Ownership Programs Are Varied and Growing

No longer just a prerogative of executives, stock ownership programs in a wide variety of forms are increasingly becoming part of the benefits package of non-managerial, unionized, and hourly employees. The diversity in stock plan design is reflective of both the goals and employee demographics of individual companies. Many employers, including many Council member companies, extend the benefits of stock ownership to their employees through stock option programs, employee stock ownership plans (ESOPs), employee stock purchase plans (ESPPs), use of company stock in 401(k) plans, and other innovative equity participation arrangements. Looking just at stock options, recent surveys show that approximately 6 million non-management employees are accumulating wealth through stock options,² and 39 percent of major companies now have stock option plans that cover over half of their workforce, up from 17 percent in 1993.³ Most notably, this growth in stock option holdings has spread to rank-and-file employees. In fact, in a 1998 survey of 389 companies that granted stock options, 34 percent made grants to such employees.⁴

While some think of stock ownership programs as being particular to start-up and high technology firms, stock ownership and participation arrangements are actually found across the whole spectrum of American industry. A glance at the 50 largest U.S. companies with broad-based stock option plans demonstrates that companies in such fields as manufacturing, banking, shipping, household products, aviation, insurance, food products, retail, rail transport, and cable TV are offering stock options to their rank-and-file employees.⁵ The depth and breadth of stock ownership programs reflected in the figures I have cited indicates that the extension of equity to rank-and-file employees is becoming an increasingly common business practice.

Benefits of Stock Ownership Programs

Broad-based stock ownership programs prove valuable to both employees and employers. Foremost, they enable workers to become owners of their company, creating a personal stake on the part of employees in the corporate venture and often providing workers with a greater sense of commitment to the company's mission. Such programs also provide a significant vehicle of wealth accumulation for many workers. Two recent studies put the average annual value of stock option grants to employees at roughly \$1,700.⁶ This wealth accumulation aspect can contribute meaningfully to employees' retirement security.

Employers appreciate stock ownership programs as an important recruitment, retention, and motivational tool in a competitive labor market. Moreover, a recent study found that there is evidence that companies with broad-based stock plans have significantly higher productivity levels and annual growth rates as compared

¹ The full survey and its results can be found on the web site of the American Benefits Council at www.americanbenefitscouncil.org.

² *Current Practices in Stock Option Plan Design*, National Center for Employee Ownership, 2000.

³ *Broad-Based Stock Options—1999 Update*, William M. Mercer, Inc., 1999.

⁴ *The 1998 Stock Plan Design and Administration Survey*, PricewaterhouseCoopers, 1998.

⁵ *Employee Ownership Report*, National Center for Employee Ownership, May/June 1999.

⁶ *Employee Ownership Report*, National Center for Employee Ownership, January/February 2000, and David Lebow et al., *Recent Trends in Compensation Practices*, Board of Governors of the Federal Reserve System, Finance and Economics Discussion Series, No. 1999-32, July 1999.

to companies without broad-based stock plans.⁷ This latter effect may translate into a benefit for the general economy as the number of companies with broad-based stock ownership plans increases.

While many American workers feel fortunate to have stock ownership plans, other workers lack this opportunity because their employers cannot, for a variety of reasons, provide such benefits. We believe that a top priority for the next Congress should be to build on your efforts, Mr. Chairman, to provide enhanced incentives for broad-based stock plans and to remove the existing barriers that can deter employers from extending the opportunity for employee equity ownership.

The Monsanto Experience

At Monsanto, both the company and our employees are firm believers in the benefits of equity ownership. We provide stock options to all of our employees, worldwide. For rank-and-file workers, we grant a fixed number of options per employee at each grant occasion. For management employees, the number of options we grant is tied to the individual manager's role and responsibilities within the company. For our employees in the United States, Monsanto will also allow workers to purchase shares of Monsanto stock through an employee stock purchase plan. We also have an employee stock ownership plan (ESOP) and offer Monsanto stock as an investment option in our 401(k) plan. As you can see, equity ownership is central to our vision of how to reward Monsanto employees. We are grateful, Mr. Chairman, for your efforts to make this system one that will work even more effectively for employees and employers alike.

H.R. 4972, The Universal Stock Options Act of 2000

Turning to a discussion of your bill, Mr. Chairman, the Council believes that H.R. 4972 marks a major step forward in the debate on improving our nation's compensation and benefits policy. Your bill would provide employers with a significant new incentive to offer stock ownership plans. If enacted, the bill would accelerate and enhance the existing trend toward providing broad-based employee stock option and stock purchase plans and could create a large new generation of employee stock owners. The potential improvements in productivity, employee economic well-being, and employment satisfaction for millions of Americans could be substantial.

H.R. 4972 would accomplish these important goals by encouraging employees to use tax-favored payroll deductions to purchase employer stock. Employees would be able to deduct amounts from their pay, up to the annual limit specified by Internal Revenue Code section 402(g), and all contributions, as well as any shares purchased by such contributions, would be placed in a trust. Employees would be taxed neither on amounts saved through payroll deduction nor on the value of the shares of stock when purchased. Employers would be allowed a deduction when options are exercised and the shares are transferred to the employee, and the deduction would be equal to the fair market value of the stock at the time of exercise. Upon sale of the stock, the employee recognizes ordinary income equal to the stock's fair market value at exercise and capital gain treatment on the amount, if any, that exceeds the exercise price.

The bill encourages both employee savings and equity ownership by coupling the power of payroll deduction with increased tax incentives. Our members can testify to the powerful effect in the 401(k) context of combining payroll deduction and pre-tax deferrals, and we believe that similarly positive results would occur with stock plans. We also believe that employees and employers will respond in a positive way to the tax incentives contained in H.R. 4972. The chief benefit of these incentives will be that employees will no longer have to sell stock as soon as they purchase it in order to cover their tax liability. Rather, they will be empowered to hold stock for longer periods, allowing an opportunity for long-term appreciation in value and a continued ownership stake in the corporation. Moreover, the Council supports the bill's accelerated deductions for employers as an important tool to encourage the establishment of new broad-based plans.

H.R. 3462, The Wealth Through the Workplace Act

In addition to H.R. 4972, the current Congress saw the introduction by Representative John Boehner (R-OH) of H.R. 3462, the Wealth Through the Workplace Act. H.R. 3462 creates a new broad-based stock option design that combines positive elements of both qualified and non-qualified stock options. H.R. 3462 would generally allow workers to defer taxation on their stock options until they sell their shares and then to have their gains taxed at capital gains rather than ordinary income

⁷Public Companies with Broad-Based Stock Options: Corporate Performance from 1992–1997, National Center for Employee Ownership and Blasi, Kruse, Sesil, and Kroumava, 2000.

rates. These are benefits that employees with qualified (or “incentive”) stock options currently enjoy. At the same time, employers would be able to take a tax deduction for the increased value of the stock option upon the employee’s exercise of the option (as sponsors of traditional non-qualified stock options may currently do).

H.R. 3462 would encourage employees to save for the future by providing that the bill’s favorable capital gains tax treatment applies only to stock options that are held for two years from the grant date and one year from the exercise date. By providing favorable rules for employees who hold their stock options for the specified periods, H.R. 3462 not only provides a vehicle for workers to accumulate wealth, but also encourages workers to take the long-term view with respect to their own financial security. In this way, the bill encourages employees to remain ongoing stakeholders in our economy and helps them achieve retirement security.

The Future for Stock Option Incentives

Mr. Chairman, the Council recognizes that, notwithstanding the strong merits of H.R. 4972 and H.R. 3462, it is highly unlikely that these bills will be enacted in the closing days of the 106th Congress. However, these bills provide an important starting point for deliberations by the new Congress. As an aside, Mr. Chairman, we understand that you and Representative Boehner have discussed possible joint initiatives in the future concerning stock options, and we would certainly applaud and encourage such cooperation. As you and others look to continue your efforts to encourage and facilitate broad-based stock option plans, we wish to add to our comments above the following items for the Subcommittee’s consideration:

- The Council believes that it will be important to clarify that any new stock option or stock purchase design will not displace or lead to adverse consequences for existing arrangements. Clear protection of existing programs will help new stock plan legislation gain broad-based support from the business and benefits communities.
- While we believe it is appropriate to include coverage requirements in any new stock plan legislation that provides substantial tax advantages, we feel such requirements should be carefully and flexibly crafted so as not to preclude employers from making use of the new incentives or designs.
- Historically, equity arrangements like stock option plans have been established within the Internal Revenue Code and regulated by the Treasury Department and Internal Revenue Service. We strongly recommend that any future legislation continue this historical practice rather than placing stock plans within the Employee Retirement Income Security Act (ERISA) and subjecting them to regulatory oversight by the Department of Labor.
- We understand that some Members of Congress may be concerned about preventing substitution of stock options for existing wages. We believe this concern is misplaced. Employers make determinations about workers’ wages and benefits in the context of the appropriate level of total compensation and decide upon the relative place of cash wages and other benefits based on what is competitive in the marketplace. These competitive pressures will not allow companies to reduce cash compensation below what workers demand and what competitor firms provide. We believe, therefore, that legislation to prevent the substitution of options for wages is unnecessary (and would in any case be highly unworkable).

Other Public Policy Issues Related to Stock Ownership Programs

Mr. Chairman, there are a number of other pressing issues related to stock ownership programs that I would like to address in my testimony this morning. As a champion of extending equity ownership to more American workers, Mr. Chairman, you have been sensitive to these issues, and we at the Council appeal to you and other members of this Subcommittee to devote your substantial energies to addressing these matters. The barriers and burdens I will describe today have the potential to erode employee stock ownership programs even as you seek to expand them.

Tax Withholding Obligations under Stock Option Plans—A disqualifying disposition of stock under a qualified Incentive Stock Option (ISO) plan results in income to the employee. However, the IRS has provided consistent guidance for nearly 30 years that the employer that grants the ISO does not have any income tax withholding obligation with regard to that income, nor is such income from either a qualifying or disqualifying disposition considered wages for FICA or FUTA withholding purposes. Since the same statutory provisions interpreted by the IRS guidance also apply to employee stock purchase plans (ESPPs) governed by section 423 of the Internal Revenue Code and since the IRS has provided similar guidance for ESPPs, employers generally have not paid employment taxes or withheld income on ESPP income.

In contrast, and despite the historic IRS guidance, the IRS has recently taken the position that FICA and FUTA taxes should be imposed whenever options are exercised under an ESPP. The amount of such tax would be based on the difference between the option price and the fair market value of the stock at the time of exercise. The IRS has also taken the view that Federal income tax withholding is required on disqualifying dispositions under ESPPs. Moreover, the IRS has sought to impose these withholding obligations retroactively despite clear and directly contradictory guidance in the ISO area.

Mr. Chairman, you have been an articulate advocate for ESPPs and have pointed out the many adverse consequences that will result from the IRS' recent change of position regarding withholding obligations. You have recognized that imposition of these tax obligations will create new and substantial burdens on employers, acting as a deterrent to the sponsorship of broad-based stock purchase programs. Moreover, if withholding is applied, you have noted that employees, particularly rank-and-file employees, are less likely to retain shares after exercise of ESPP options because they will have to sell the stock to cover the additional tax liability. This hinders employee wealth accumulation and frustrates the opportunity for long-term appreciation in share value. In addition, the new demand for tax withholding increases tax and administrative costs and discourages employers from offering stock options to rank-and-file employees.

As you know, Mr. Chairman, these withholding issues are currently being litigated in the Federal Court of Claims, and the Council has urged the IRS to return to its long-standing position that income and payroll tax withholding obligations for ESPPs should parallel those for ISOs. We have greatly appreciated your leadership in urging the IRS to desist from its current enforcement efforts and return to its prior practice. We are very concerned, however, that the IRS and Treasury are poised to issue guidance that could support the imposition of employment tax and withholding obligations on certain ESPP and perhaps even ISO transactions.⁸ Because of the counter-productive results of such an approach for employees and employers alike, we believe that legislation will likely be needed to overturn the agency guidance and clarify that income and payroll tax withholding obligations do not apply for ESPPs and for ISOs.

Alternative Minimum Tax—A major obstacle to extending equity ownership to working Americans has been the application of the alternative minimum tax (AMT) to stock option transactions. Upon exercise of an ISO option, the difference between the fair market value of the stock and the exercise price is includible in AMT income even though this amount is not includible in ordinary income. The application of the AMT to stock options discourages workers from holding company stock and thereby frustrates many of the goals of stock ownership programs. The Council strongly supports legislation to make clear that the AMT would not apply with respect to the exercise of options under ISOs.

Employee Classification Issues—Employee stock purchase plans (ESPPs) are generally required to cover all common law employees of the corporation. However, employers may exclude certain narrowly defined groups of workers based upon their status as part-time, short service, highly compensated or new employees. Litigation has arisen over whether temporary and part-time workers are entitled to participate in ESPP plans, and questions also exist with respect to whether certain foreign employees must be covered under these plans. Employers who sponsor ESPPs and other stock ownership programs need flexibility in managing benefits for a workforce with changing demographics. This needed flexibility would be impaired by legislating aggressive new coverage mandates (as some Members of Congress have proposed), the result of which would be fewer stock plans that include rank-and-file workers. Particularly in light of the already broad coverage requirements of ESPPs, we urge Congress to stand firm against such mandates and to continue to allow employers needed flexibility in administering their benefit programs.⁹

⁸While we expect to take issue with the substance of any forthcoming guidance reaching such a conclusion, we feel strongly that, at a minimum, such guidance should be prospective in nature and should be issued in proposed rather than final form. Issuance of retroactive guidance and/or denying the public an opportunity to comment would impose an unfair burden on the many employers who have reasonably relied on the IRS' long-standing and contrary position.

⁹There are also ways in which the existing ESPP rules work to exclude workers inappropriately from participation in these plans. The current rules require that in order to participate in an ESPP, an employee must work for a corporation (rather than for a partnership or limited liability company (LLC)) and that at least 50 percent of that corporation must be owned by the firm sponsoring the ESPP. Both of these rules exclude workers from ESPP participation, particularly in start-up firms that often take the form of partnerships or LLCs and in joint ventures where the 50 percent ownership threshold is not met. We urge Congress to review these rules.

ESOP Dividends Reinvestment—Employee stock ownership plans (ESOPs) allow employees to share in the benefits of equity ownership through the vehicle of a tax-qualified retirement plan. The Comprehensive Retirement Security and Pension Reform Act, H.R. 1102—of which many members of this Subcommittee are cosponsors—includes an important change in the tax treatment of ESOP dividends that would provide employees with a greater opportunity for enhanced retirement savings and stock ownership. Under Code section 404(k), employers may take a tax deduction on dividends paid on employer stock in an unleveraged ESOP only if the dividends are paid to employees in cash; thus, the deduction is denied if the dividends remain in the ESOP for reinvestment. Under H.R. 1102, deductions would also be allowed when employees choose to leave the dividends in the plan for reinvestment, encouraging the accumulation of retirement savings through the employee's ownership interest in the employer. This provision will make ESOPs even more effective retirement savings plans. This important ESOP dividend reinvestment provision is but one of the many reasons the Council is working actively with Congress to see H.R. 1102 enacted into law in the remaining days of this congressional session.

Information Reporting of Stock Option Transactions—Nonqualified stock option plans are the most common type of stock option plan in use by employers. Upon exercise of such options, the employee receives income equal to the excess of the fair market value of the stock over the option exercise price, and such income is reported on the employee's Form W-2. The employee typically sells the stock on the same day that the option was exercised (unless a restriction applies). The broker handling these transactions is required to report on Form 1099-B the payments of gross proceeds to individuals from such same-day sales (even though typically no gain or loss is realized). The end result is that the employee receives duplicative reporting for the same transaction (on both the W-2 and the 1099-B), which can cause confusion. Moreover, if the employee has not provided a certified taxpayer identification number on Form W-9, the broker is required to backup withhold 31 percent from the gross proceeds of the sale in addition to withholding employment taxes. For many employees, particularly those working abroad, unintentional errors in W-9 reporting can lead to unfairly large tax burdens. The Council recommends that the Congress examine these issues and explore ways in which the reporting requirements of the Code can be simplified and streamlined in order to minimize confusion and reduce needless tax burdens.

The Effect of Auditor Independence Rules on Stock Plan Participation—We also wanted to bring to the Subcommittee's attention the effect that the Securities and Exchange Commission's (SEC) requirement that accountants be independent of their corporate clients can have in the stock plan context. These independence rules require that no dependents of the accountant may own shares in a company that the accounting firm audits. These rules are incredibly complex to apply and often exclude the spouses and children of accountants from the stock-related plans their employers offer. The result has been not only a burden on the non-accountant working spouses (who must sacrifice valuable benefits their employers provide) but also a barrier to attracting the best and brightest to the accounting profession (as potential candidates choose other professional paths rather than navigate these rules and sacrifice the attendant economic benefits). While independence rules are essential to maintaining the integrity of corporate audits, we believe the effect of these rules in the stock plan context is worthy of examination. As Congress continues its oversight of the SEC's revision of the auditor independence rules, we urge attention to the issue of stock plan participation by auditor family members.

International Concerns—Many U.S. companies operating internationally find that offering stock and stock options to employees overseas is difficult because of the differing tax treatment of stock offerings, dividend distributions, and sales of shares across different countries. The Council urges the Congress to help promote more uniform treatment for employees of U.S. companies by investigating the special problems of offering equity ownership to U.S. workers working in other countries.

Conclusion

I want to thank you, Mr. Chairman, Ranking Member Coyne, and the other members of the Subcommittee for your interest and dedication to promoting equity ownership by American workers. We look forward to continuing to work with you and other interested Members to enact new incentives to extend broad-based stock plans to more American employees and to develop and advance solutions to the barriers and burdens confronting stock plans today. Both steps will help us to maintain the positive trend in our economy toward broad-based employee stock ownership.

Thank you, and I would be pleased to answer any questions you may have.

Chairman HOUGHTON. All right. Fine. Thanks very much, Ms. Schopp.

Now, Ms. Sussman, who is the Executive Director of the National Association of Stock Plan Professionals.

**STATEMENT OF SANDRA L. SUSSMAN, EXECUTIVE DIRECTOR,
NATIONAL ASSOCIATION OF STOCK PLAN PROFESSIONALS,
SILVER SPRING, MARYLAND**

Ms. SUSSMAN. Good morning, Mr. Chairman. Thank you for the opportunity to appear before the subcommittee on behalf of my organization and its members. My name is Sandra Sussman. I am the Executive Director of the National Association of Stock Plan Professionals, which is a professional association for individuals who are involved directly or indirectly with the design and administration of employee stock plans.

The NASPP was formed in January of 1993 and currently has a little over 6,000 members who are in-house securities and tax attorneys, human resources professionals, accountants, compensation and benefits professionals and stock plan administrators, as well as outside providers of stock plan-related services, such as outside counsel, compensation consultants, software vendors, brokerage firms, third-party plan administrators, communications professionals and web-based service professionals.

Our membership represents roughly 2,500 public companies of all sizes and industries, all of which have one-or-more employee stock plans in place. Based in part on the results of our biannual plan design and administration surveys, we believe that the current applicable corporate tax treatment of equity based compensation and awards has led most companies to grant non-qualified stock options to employees; that is, because non-qualified awards ultimately involve a tax deduction for the company, as my colleagues have already expressed.

We also believe, perhaps more importantly, that the current tax treatment has resulted in most companies not discouraging disqualifying dispositions of stock acquired through the exercise of incentive stock plans or through Section 423 employee stock purchase plans, even though employee equity ownership is most certainly becoming desirable.

While our members have not to date expressed any real opinion about either Representative Houghton's proposal, that is, the Universal Employee Stock Option Act of 2000, H.R. 4972, or Representative Boehner's Wealth Through the Workplace Act, H.R. 3462, we do believe our member companies would very much appreciate the availability of an alternative approach that would provide for more favorable tax treatment for companies and their employees alike, thereby encouraging greater employee ownership.

Toward that end, the NASPP would strongly encourage the re-introduction next year of legislation that would improve the tax advantages of employee stock options. Going forward, we will be pleased to provide input to the staff drafting the legislation based upon the views of our regional leadership, which we will indeed solicit.

Thank you again for this opportunity. I am happy to take any questions that you have.

[The prepared statement follows:]

Statement of Sandra L. Sussman, Executive Director, National Association of Stock Plan Professionals, Silver Spring, Maryland

Good morning, Mr. Chairman. Thank you for the opportunity to appear before the Subcommittee on behalf of my organization and its members. My name is Sandra Sussman. I am the Executive Director of the National Association of Stock Plan Professionals, which is a professional association for individuals involved, directly or indirectly, in the design and administration of employee stock plans. The NASPP was formed in January of 1993 and currently has over 6,000 members who are in-house securities and tax attorneys, accountants, human resources professionals, compensation and benefits professionals and plan administrators, as well as outside providers of stock plan related services, such as outside counsel, compensation consultants, software vendors, brokers, third party administrators, communications professionals and web-based services professionals.

Our membership represents roughly 2,500 public companies, of all sizes and industries, which have one or more employee stock plans in place. We believe that the current applicable corporate tax treatment of equity-based compensation and awards has led most companies to grant non-qualified stock options to employees, that is, because non-qualified awards ultimately involve a tax deduction for the company. We also believe, perhaps more importantly, that current tax treatment has resulted in most companies *not* discouraging disqualifying dispositions of, say, stock acquired through Section 423 employee stock purchase plans, even though employee equity ownership apparently is becoming more desirable.

While our members have not, to date, expressed an opinion about Representative Houghton's proposal (that is, the Universal Employee Stock Option Act of 2000, H.R. 4972), we believe our member companies would very much appreciate the availability of an alternative approach that would provide more favorable tax results for companies and their employees, thereby encouraging greater employee ownership. Toward that end, we would strongly encourage the re-introduction next year of legislation to improve the tax advantages of employee stock options.

We would be pleased to provide input to the staff drafting the legislation, based upon the views of our regional leadership that we will solicit.

Thank you. I am happy to take any questions you might have.

Chairman HOUGHTON. Thank you, Ms. Sussman.

Now, Mr. Butler is the Principal, Practice Leader of Employee Ownership Programs at Hewitt Associates.

STATEMENT OF MICHAEL J. BUTLER, PRINCIPAL AND PRACTICE LEADER, EMPLOYEE OWNERSHIP PROGRAMS, HEWITT ASSOCIATES, ROWAYTON, CONNECTICUT, ON BEHALF OF THE U.S. CHAMBER OF COMMERCE

Mr. BUTLER. Mr. Chairman and members of the subcommittee, Mr. Boehner, thank you for the opportunity to participate in this hearing. My name is Michael Butler. I'm a principal with Hewitt Associates, a global management consulting firm specializing in all aspects of employee benefits, compensation and human resource solutions.

Hewitt Associates has extensive experience with broad-based employee ownership and equity compensation programs, both domestic and global. I presently serve as Hewitt's Global Practice Leader for Employee Ownership Consulting Services. Hewitt Associates is a member of the U.S. Chamber of Commerce, where we serve on the Employee Benefits Committee. I am here today at the request of the Chamber to share our perspective on employee stock options and other forms of broad-based employee ownership based on our

experience working with literally hundreds of client organizations on all aspects of employee ownership.

In recent years, as has been noted, we have seen a significantly heightened interest in stock options as an innovative way to compensate and reward employees. I am pleased that Congress and this committee in particular have taken an interest in this issue and I applaud your leadership and Mr. Boehner's in this important area.

In my remarks today, I would like to touch on four primary observations that I think may be helpful in framing your consideration of this issue. The first deals with the explosion in popularity of employee ownership. As has already been noted, there has been a dramatic increase in practice in the use of both stock options and stock purchase plans. The National Center for Employee Ownership estimates that somewhere between seven to ten million Americans are receiving stock options today.

A 1999 survey by the same organization indicates that there were approximately 4,000 stock purchase plans covering approximately 16 million U.S. participants at the end of 1998, and those numbers are certainly higher today. Add in ESOPs and the use of company stock within 401(k) plans and other mechanisms and the numbers jump even higher.

In other words, employee ownership in the U.S. is thriving today under existing law. While additional tax and other incentives such as those contemplated by your legislation and Mr. Boehner's would certainly be welcomed by employers and would certainly be productive in the sense of creating additional mechanisms for extending ownership, a key goal that we hear from our clients is basically retaining the overall simplicity and flexibility that is inherent in today's structures.

One of the reasons that the United States is leading in this area globally is that our laws permit the kind of adaptation, flexibility and experimentation that are difficult to pursue elsewhere. We are seeing very interesting experiments currently among our clients with things like accelerated vesting provisions, indexation of options to reflect broader industry performance and the inclusion of performance-oriented features to reward specific kinds of achievement.

Any provision that adds additional tax incentives will certainly be welcomed and appreciated, but we need to be careful not to hamper the kind of flexibility that currently is so important in driving the success we have seen in this area so far. Echoing your comments, Mr. Chairman, I think it is important also to note that the extension of employee ownership certainly has contributed to the remarkable performance of our economy over the past 10 years.

The study by Rutgers noted earlier, as well as other research we have done in conjunction with Northwestern University and other studies clearly indicate that there is a strong correlation between the broad sharing of employee ownership and superior economic results. I do not think it is too far-fetched to suggest that the effective use of employee ownership strategies is contributing to the overall competitiveness of U.S. business and has, in fact, been a factor in the remarkable performance of our economy recently.

The point really is the effective use of ownership. Simply extending ownership without changing other corporate practices, we have found to be of limited value. As a couple of the prior witnesses noted, the extension of employee ownership in the context of teamwork, broader sharing of information, broader encouragement of empowerment among the broad workforce is really what drives these results. Ownership in and of itself is certainly desirable. Ownership in conjunction with enlightened corporate practices is really what we see driving results.

The third point I would like to touch on is the international perspective. This explosion in interest in employee ownership programs is not strictly a U.S. phenomenon. We have worked with over 20 major U.S. employers to extend broad-based option and purchase plans to literally hundreds of thousands of employees in well over 100 countries. We have also worked with dozens of non-U.S. employers in implementing broad equity programs for employees in their home countries and increasingly for their employees around the world.

At the present time, we are actively working with clients in more than one dozen countries outside the U.S. and are aware of activity in several more. In considering legislative initiatives to encourage and expand employee ownership practices, I think we need to look beyond our borders to understand the global context within which these plans increasingly operate.

A program that confers tax or other advantages in the U.S., but might lead to some degree of inflexibility and make a program unsuitable for global implementation, could cause some difficulties for the growing number of U.S. multi-nationals that are extending employee ownership to their people around the world, as well as non-U.S. employers looking to extend ownership to their employees in the United States.

In summary, employee ownership is a significant and growing force here and abroad. Used effectively, it certainly has a demonstrable connection with superior economic results and the utility of this approach is increasingly being recognized around the world. The U.S. has been a pioneer in this area largely because of the flexibility of our broad ownership mechanisms. There are certainly opportunities to build on this success by creating new opportunities and new mechanisms, but we must be careful not to trigger unhealthful side effects by adding too much complexity or burdensome regulatory requirements in our quest to improve on what is already a very successful array of practices.

Thank you for the opportunity to testify today. I would be happy to respond to any questions and follow up with the committee staff with further information.

[The prepared statement follows:]

Statement of Michael J. Butler, Principal and Practice Leader, Employee Ownership Programs, Hewitt Associates, Rowayton, Connecticut, on Behalf of the U.S. Chamber of Commerce

Mr. Chairman and members of the subcommittee, thank you for the opportunity to participate in this hearing. My name is Michael Butler. I am a Principal with Hewitt Associates, a global management consulting firm specializing in all aspects of employee benefits, compensation, and human resources solutions. Hewitt Associates has extensive experience with broad-based employee ownership and equity com-

pensation programs, both domestic and global. I presently serve as Hewitt's global practice leader for employee ownership consulting services.

Hewitt Associates is a member of the U.S. Chamber of Commerce, where we serve on the Employee Benefits Committee. I am here today at the request of the Chamber to share our perspective on employee stock options and other forms of broad-based employee ownership, based on our experience working with hundreds of client organizations on all aspects of ownership programs.

In recent years, we have seen a significantly heightened interest in stock options as an innovative way to compensate and reward employees. I am pleased that Congress is taking an interest in this issue as well.

In my remarks today, I will outline four observations that may be helpful in framing your consideration of the stock option issue:

- Growth in Popularity of Stock Options in the U.S.

There has been an explosion of interest and activity in this area over the past ten years. The National Center for Employee Ownership conservatively estimates that seven to ten million U.S. employees are receiving stock options. A 1999 survey by the NCEO indicates that there were more than 4,000 stock purchase plans with approximately 16 million U.S. participants at the end of 1998. Those numbers are certainly higher today. Add in employee stock purchase plans (ESOPs), company stock in 401(k) plans and other mechanisms, and the numbers jump dramatically.

In other words, employee ownership in the U.S. is thriving under existing law. While additional tax and other incentives would certainly be welcomed by employers, and could stimulate and channel activity in this area, a key goal should be retention of the overall simplicity and flexibility inherent in today's environment.

There is a great deal of experimentation going on today as employers adapt to meet competitive pressures and extend their plans globally. For example, over the last several years in Silicon Valley, it has become popular to utilize a very rapid vesting schedule for stock options. Whereas prior to the late 1990s, a three or four year vesting schedule was typical, now it is common to have 50 percent of options vest at one year, with the remainder vesting monthly after that.

Tax or other incentives that come with provisions that hamper this creativity or limit employer flexibility would be a mixed blessing at best, and quite possibly counterproductive.

- Desirability of Stock Option Plans

Maintaining the vitality of the existing environment is an issue for our economy as a whole, not just employers and participants in these plans. There is a considerable and growing body of research, from a variety of sources, strongly supporting the proposition that, all else being equal, organizations providing a meaningful equity stake to the broad workforce generally outperform those that do not, especially when combined with participative workplace practices. For example, researchers at Rutgers University have documented a 16 percent improvement in productivity and two percent improvement in return on assets by firms beginning a broad-based stock option plan.

In light of these findings, it is not too farfetched to suggest that effective use of employee ownership strategies is contributing to the overall competitiveness of U.S. business, and has been a factor in the remarkable performance of our economy over the past decade.

Broader employee ownership may be desirable as a matter of social policy for a number of reasons. But, from a business perspective, it is the *effective* use of these mechanisms that matters. In evaluating different approaches, keep in mind that there is a distinction between simply incenting employee ownership, and use of broad employee participation and involvement as a source of competitive advantage. For example, Hewitt research has shown that there are three necessary components to using stock options to enhance productivity:

- Explaining to employees their role in the company and what the company needs to do to stay competitive, should not be left to the board room, but instead, should be broadly disseminated;

- Fostering an environment that encourages individual and collective success, provides a steady flow of relevant business information, and empowers employees; and,

- Sharing equity in the company.

My point here is that broad employee ownership is desirable not only in terms of fairness and broader sharing of wealth, but also as a matter of national competitiveness. Governments from the U.K. to China have explicit policy objectives aimed at increasing employee ownership, because they see a connection between our prac-

tices in this area and the extraordinary productivity of our economy. In considering legislative alternatives aimed at fostering greater employee ownership, we must not lose sight of the connection to results.

- The International Perspective

As noted earlier, the stock option explosion is not just a U.S. phenomenon. Hewitt Associates has worked with over 20 major U.S. employers to extend broad-based stock option and stock purchase plans to hundreds of thousands of employees in well over 100 countries. We have also worked with dozens of non-U.S. employers in implementing broad equity programs for employees in their home countries, and increasingly, for their employees around the world. At the present time, we are actively working with clients based in at least a dozen countries outside of the U.S., and are aware of activity in many more.

In considering legislative initiatives to encourage and expand employee ownership practices, we need to look beyond our borders to understand the global context within which these plans exist. A program that confers tax or other advantages in the U.S., but which is inflexible or structurally unsuitable for global implementation could cause serious difficulties for the growing number of U.S. multinationals extending ownership world wide, as well as for non-U.S. employers looking to extend equity participation to their U.S. employees.

For example, one common obstacle we often face in a number of other countries is the inability to modify or eliminate a stock option program once it has been put into place. This is not a problem in the U.S. because of flexible law that enables companies to adapt to the changing business environment on an ongoing basis.

In another instance, one U.S. multinational employer has established a global stock purchase plan, complete with payroll deductions and an employer match. While not fully aligned with the U.S. plan, due to differences in the law, the goals of the foreign and domestic plans are the same: to encourage employee equity in the company. Flexibility in U.S. law has enabled employers to mimic plans in other countries, expanding the global reach of employee ownership.

- Refrain from ERISA-like Regulation

In considering legislation to expand the use of stock options, I urge Congress to keep stock option plans separate and distinct from qualified benefit plans that are regulated under the Employee Retirement Income Security Act (ERISA). Requirements such as nondiscrimination testing, contribution limits, compensation limits, that are at the heart of ERISA will create an enormous disincentive for employers to offer stock options on a broad basis to their workers.

In summary, employee ownership is a significant and growing force here and abroad. Used effectively, it has a demonstrable connection with superior economic results, and the utility of this approach is increasingly being recognized around the world. The U.S. has been a pioneer in this area, largely because of the flexibility of our broad ownership mechanisms. There are certainly opportunities to build on this success by creating new vehicles and enacting new incentives, but we must be careful not to trigger unhelpful side effects by adding too much complexity in our quest to improve an already very successful array of practices.

Thank you for the opportunity to testify before the Subcommittee today. I'd be happy to respond to any questions or follow up with further information.

Chairman HOUGHTON. Thanks very much, Mr. Butler.

Now I would like to ask Mr. Coyne to inquire.

Mr. COYNE. Thank you, Mr. Chairman.

Mr. Cook, based on your long experience in this field that you outlined earlier, what do you consider is the key to getting employees to participate in these stock option plans?

Mr. COOK. Sir, the question was what is the key to getting employees to participate. I believe the key, as identified in Chairman Houghton's bill, would be to permit employee contributions to be made on a pre-tax basis. They now are required to be made on a post-tax basis. That puts employee stock purchase plans at a disadvantage versus Section 401(k) plans, where pre-tax contributions are made. That is my answer, sir.

Mr. COYNE. Ms. Sussman, I wonder if you could profile what types of employees currently participate in these plans.

Ms. SUSSMAN. What types of employees currently participate in all sorts of plans?

Mr. COYNE. Yes. Who are the ones that generally take advantage of this? Is there a profile to these employees?

Ms. SUSSMAN. We don't have a profile, per se. But based again on the surveys that we conduct every other year, what we have seen is plans are typically a little bit more top-heavy, but over the last couple of years plans have been pushed further down into the ranks. So, at this time, I still think there are more higher-level employees that are involved in employee stock plans, the incentive stock options, the restricted stock awards, those types of things. But broad-based plans are becoming a little bit more prevalent and they tend to participate in employee stock purchase plans, non-qualified options. But management versus rank-and-file is really where we see the differences in employees. Does that answer your question?

Mr. COYNE. Yes.

Mr. Capuano, is that the experience you have seen in your company?

Mr. CAPUANO. Proxicom is generally considered to be part of the high-tech industry and we do not have a culture of management and rank-and-file. In the high-tech industry, everybody participates. The participation creates a passion that exists within the company, to succeed. High-technology is a very competitive industry. It is a global industry, and these options create a real sense of ownership and passion in our employees to succeed, to have the company succeed.

So, because it is a competitive industry and we need this passion to succeed, there is no management and rank-and-file, and everybody typically participates.

Mr. COYNE. So, you don't see this separation from the higher-paid employees versus the lower-paid employees in taking advantage of these stock options?

Mr. CAPUANO. Oh, absolutely not. Absolutely not. Everybody needs to be incented across the board in this industry. Absolutely not. Everybody participates.

Mr. COYNE. Thank you.

Chairman HOUGHTON. Mr. Boehner?

Mr. BOEHNER. Well, thank you, Mr. Chairman. Again, thank you for having the hearing and thank you for inviting me to come. Let me thank the witnesses for what I think was very excellent and helpful testimony.

Mr. Capuano, the purpose of stock options is obviously to help employees think like owners. But, as you described, when workers exercise their option, the current tax treatment of many of those options really does, in fact, force them to sell their shares.

I guess my concern is what happens to the employee? What happens to the management team in terms of the incentives for the employee to be a strong member of the team, as opposed to the idea that we have been discussing about encouraging employees to hold their shares for longer periods of time?

Mr. CAPUANO. The employees, by being forced to sell shares of stock in a company such as Proxicom that they have a passion to build, creates a couple feelings. There is a sense almost of disappointment, and I have had and I have seen, as the employees come knocking on my door, trying to figure a way of how they should deal with this situation, a true sense of disappointment that they have to sell shares in a company that they are passionate about building.

In the bigger scheme of things, we feel it creates an unnecessary risk that our shareholder employees are becoming detached from the long-term success of the company. We want all of our shareholder employees to be long-term holders. That is not to say that they are not going to sell over time, but it definitely creates an unnecessary division between long-term ownership and the success of the company. I hope that answered your question.

Mr. BOEHNER. Well, let me expand on that just a bit. Can you paint a picture for me of what you think would happen to your fellow employees if, in fact, the company got a deduction for the value of the stock option, if the employee had no tax treatment until such time as they actually sold the shares, but not at exercise, and, thirdly, if, in fact, they held those shares for at least a year, they got capital gains treatment?

What you think the advantages or disadvantages to both the company and to your employees would be?

Mr. CAPUANO. The real advantage to the company will be very strategic. The employees, again because they are—especially in this very competitive industry—very, very excited about being owners of our company, they will hold the stock. I am not going to say everybody will. But I know the Proxicom employees. They will hold the stock. They will be shareholder owners and it will drive our growth that much more.

What we sacrifice by having them sell early is up-side to both the company and the employees. And it is real and you see it when you have the employees knocking on your door, disappointed about having to sell early. They want to share in the up-side. They want to drive the up-side of the company.

So, you have two areas of concern. Again, from a strategic perspective, we see a real value in having our employees be long-term shareholders. We know that drives our bottom line, profitability. From our employees, we also see that they sacrifice gain. And I have seen it from a very real perspective when they are forced to sell early and the stock has appreciated.

Mr. BOEHNER. To Ms. Schopp and Mr. Butler, my interest in this is trying to find a way to encourage more companies to offer stock options to a wide array of their employees. Clearly, I would hope that companies that would take advantage of this idea, if it becomes law, would encourage them to all of their employees.

My question is do you think that—either the package—and not that I want to get into a debate about my package versus Mr. Houghton's—but do you believe that the concept that we are both talking about would encourage more employers to offer a wide array—offer stock options to a wider array of their employees?

Ms. SCHOPP. It has merit for both employers and employees. I think the bills provide the flexibility for employers to be able to

pick the elements that make sense within their strategy and their focus and it allows employees to really have the opportunity to take an ownership interest in their company. I think from a real example perspective, Monsanto first granted broad-based stock options to all employees worldwide in 1996.

So, we have had the opportunity over that time frame to see the real impact that that has had on our people. As we go to our plants around the world and we see our hourly technicians really taking a real interest in the performance of Monsanto and the stock price and what they can be doing on a day-to-day basis to make Monsanto a better place to work and more economically viable, it has really been a real learning experience for us in the design of our programs.

So, I would really encourage continued emphasis on the areas that you have been both focusing on, because I think that they both have a real place in the ownership needs of companies and employees going forward.

Mr. BUTLER. If I can add to that, yes—I think the simple answer is yes, additional tax incentives will tend to accelerate the trend that we are already seeing playing out. There are larger forces at work in terms of competitiveness, the shift to a knowledge-based economy and so forth that are leading employers to look to alternative forms of compensation like this already.

I think making it more attractive from a tax perspective on both the employer and employee sides will certainly accelerate and extend that trend. One additional point, though, I think there is an important distinction to keep in mind and it points to a common area of confusion for people delving into this area for the first time, and that is simply the nomenclature of stock options versus stock purchase plans.

Obviously, there is a good deal of overlap and there are good reasons that the term "stock options" is often used in the context of stock purchase plans, but there is a fundamental structural difference between the two. If we are looking for the broadest application and the broadest participation in company equity, generally speaking, that leads you towards a true stock option kind of alternative.

We see that being used for broad-based programs, where companies are extending options to very broad populations on essentially an automatic basis. There is no payroll deduction required. There is typically no out-of-pocket money required, and therefore it is very easy for a company to say we are going to essentially extend this practice to all employees or some other very broad definition.

When you are dealing with a voluntary, contributory kind of plan, typically stock purchase plans, where you are asking people to sign up for payroll deduction (and this gets to the point Mr. Coyne was mentioning before), you do tend to see somewhat skewed participation because the simple reality is you are asking people to allocate a limited pool of discretionary dollars.

So, you do see participation in voluntary plans like stock purchase plans somewhat skewed towards the higher end of the pay scale because the simple reality is lower-paid people do not necessarily have the additional discretionary income to participate. So, extending the plan is one thing; actually getting a broad cross-section

tion of the population participating is another, and the broadest participation tends to come with options rather than purchase plans because it is simply easier to do that on an automatic basis.

Ms. SCHOPP. If I could add one item; over the years, employees have really now understood the advantage of pre-tax contributions and payroll deductions, I think as Mr. Cook mentioned earlier. And I think that the features in the employee stock purchase plan that would add those features to stock purchase plans would really be valuable and I think employees would understand them very quickly because they are used to those kind of features in 401(k) plans.

Chairman HOUGHTON. Thanks very much.

Mr. Weller?

Mr. WELLER. Thank you, Mr. Chairman, and I want to commend you for conducting what I think is an important hearing; and, of course, I also salute you and Mr. Boehner for your leadership on initiatives to promote what I label worker capitalism. I am a strong believer in giving the workers equity and giving them an opportunity to have a stake in the success of a company; and I certainly believe it not only rewards workers, but it motivates workers to move their company and their organization forward.

Mr. Butler, I would like to direct my first question to you. I am one who believes that our tax code has an impact on global competitiveness. I believe our tax code has an impact on our ability not only to compete overseas, but also to attract and keep employment here in America, whether it is our outdated depreciation treatment of various assets or other tax issues.

But the question I have for you, you have indicated that your company does business around the world.

Mr. BUTLER. Yes.

Mr. WELLER. And I was just wondering, from your perspective, do you believe encouraging employee ownership and giving employees a greater personal ownership stake in individual companies helps the United States from a global, competitive standpoint?

Mr. BUTLER. Not only do I believe that, certainly our clients believe that; and interestingly so do an increasing number of foreign governments. There are specific policy initiatives in the U.K. and China, for example, that are explicitly aimed at increasing the level of employee ownership because they understand—they believe very firmly—that one of the components of our economic success has been our ability to use these kinds of broad ownership mechanisms very effectively to drive economic performance.

Some of my colleagues are currently working with senior officials in the Ministry of Finance in China, providing technical advice on creating a framework for stock options in China. So, yes, I firmly believe it. Our clients firmly believe it, and increasingly people who have looked at the issue around the world believe that an effective structure that not only permits, but promotes broad employee ownership is absolutely a contributing factor to economic success.

Mr. WELLER. Well, China and many of these other companies are competitors of ours on an economic front; and obviously we want free and fair trade with them. Of course, with the enactment of permanent normal trade relations with China, we have made that commitment to our friends in China. Let me ask you this. These other countries that you are helping develop policies to encourage

greater employee-and worker-ownership of companies, do they have policies that we do not have which are better and that are working there?

Mr. BUTLER. Let me give you the two specific examples I mentioned, the U.K. and China. In the U.K., there actually is new legislation just passed this summer that creates a vehicle that in many ways reflects elements of both Mr. Boehner's and Mr. Houghton's bills. It is essentially a pre-tax payroll deduction, stock purchase opportunity with a matching feature that resembles these proposals in many respects.

So, yes, in the U.K. in particular, there is a program in place it is expected to contribute significantly to the extension of employee ownership. They have a long tradition of it already and it is generally felt in the ownership community that the new legislation will, in fact, promote broader use of these approaches.

In China and lots of other less-developed countries, the issues are rather different. It is not so much do they have programs that we do not or tax or other structures that we do not that would encourage it. In fact, in a number of countries like China, the real barrier to effective use of these programs is that they do not have a well-developed structure of property rights and contract rights and clarity around tax and securities treatment.

Increasingly, that is being addressed around the world and I mentioned the other countries—

Chairman HOUGHTON. Can I just interrupt, Mr. Butler? We really do have a time crunch here. So, if you could shorten those answers so Mr. Weller can ask some other questions.

Mr. WELLER. I will let him finish answering the question and then I will be done. How about that, Mr. Chairman?

Chairman HOUGHTON. Thank you.

Mr. BUTLER. The point is really that around the world an increasing number of countries are in the early stages—primarily outside of Europe—in the early stages of developing an infrastructure that will allow for the further development of these kinds of practices. I think it is fair to say the U.S. is head and shoulders above the rest of the world. The U.K. and France have fairly well-developed practices. But outside of those two examples, we clearly have been the pioneers, are continuing to be the leaders. And with these kinds of initiatives, I think we will maintain our leadership position.

Mr. WELLER. Thank you. May I ask one more?

Chairman HOUGHTON. Yes.

Mr. WELLER. Thank you, Mr. Chairman. Actually, let me direct my last question—I know we have a vote here and we are a little limited on time—to Ms. Sussman, from the perspective of the National Association of Stock Plan Professionals. The public perception of stock options is that it is a new-economy thing. You hear of these high-tech start-ups that are a few days old and they are offering stock options to attract talent to come to work for them.

What is, from your perspective, the more traditional, older, established old-economy companies? Are you seeing more and more of the older, more-established companies looking at setting up stock option plans and what are some of the challenges that they have converting to that type of employee benefit?

Ms. SUSSMAN. I think older, more-established companies have always had stock option plans. I think they have typically been more geared toward the higher-level employees, senior executives, key employees, even though all employees are technically eligible to participate. I think, as the new-economy companies have come into being, the challenges for the older, more-established companies has been to offer more, bigger option packages and push those further down into the company so that they can, in fact, retain the workers that would otherwise be going to the .coms.

It has become a big issue. It is a big challenge for the bigger companies and what we have seen are different types of option programs coming into being that pretty much can compete with the .com companies. There are other restricted stock awards that have come into play; gosh, all sorts of other things, huge bonuses and retention packages, all of those things that are keeping people or are trying to keep people from going off to the .coms.

But I think they have always had them. They have just had to take on a different face in order to compete successfully and keep those workers.

Mr. WELLER. So, the older, more-established companies, from what you are saying, are now looking at not just giving this benefit to their senior management, but also to the assembly line worker and their clerical help and administrative help in the offices?

Ms. SUSSMAN. Yes, even though it may be a token sort of plan. I mean, we have seen a lot of that, too; 100 shares for a founder's grant or 100 shares annually or 100 shares every three years or something like that. I mean, they are very token plans in many cases and very simple; and they set them up so that they are very simple to administer. But, yes, there seems to be sort of a trend toward that.

Mr. WELLER. Will Chairman Houghton's legislation, as well as Mr. Boehner's legislation, would that help these older, more-established companies make this kind of conversion so that the little guys and little girls in the old-economy companies will also be able to participate?

Ms. SUSSMAN. To the extent that most of the broad-based plans that I have seen are non-qualified in any event, it is not clear to me how that would really make that much of a difference. I think, for employee stock purchase plan participation, some of the initiatives to make that a pre-tax payroll deduction, greater tax incentives along those lines—I think would help that sort of plan. The broad-based plans that I have seen are typically non-qualified anyway, which companies are happy to do because of the tax deduction that that involves. So, it is not really clear to me how that would play out.

Mr. WELLER. What is the biggest challenge these old-economy companies have in making that kind of conversion, to giving their employees further down the pecking order the opportunity to participate? What is the biggest roadblock?

Ms. SUSSMAN. Administration. The bigger the company, the bigger the administrative issues are involved. You know, you get an IBM or any other huge company that has got 30,000 or 40,000 employees here and abroad to grant a one-time grant of 100 stock options to every employee worldwide and it becomes sort of an admin-

istrative challenge, especially if it is going to be just a one-time thing or if everybody is going to be cashing out immediately through a cashless exercise sort of mechanism.

I would say that that is probably the biggest issue.

Mr. WELLER. Thank you.

Thank you, Mr. Chairman, for holding this hearing.

Chairman HOUGHTON. Not a bit. Thanks very much, Mr. Weller.

We have got a time crunch. You have never heard that before—have you—because we have got to go over and vote now. But let me just sum up in my own mind here. If I understand what you are saying, that the basic building blocks of either Mr. Boehner's or my bill does what you want; in other words, all employees, virtually all employees are eligible; the tax consequences in terms of pre-tax contributions for employees are what you want; the deduction at fair market value the day of exercise for employers is right; and have no implications for the AMT on the exercise of these options.

Am I summing that up right? Are there any other things—because if I am and we want to keep in touch with you, then we are going to go right ahead and plow through this. Have you got any comments?

Mr. COOK. Mr. Chairman, I think that is an excellent summary. I would merely only add one, and that is that the legislation should address the employment tax, FICA and Medicare obligations on employees when they pay ordinary income tax. That would be a very important feature, too. The AMT broad-based participation, pre-tax and corporate tax deduction, as you summarize, those are the foundations of encouraging companies to offer these plans more and to encourage the employees to participate at a greater level of participation.

Chairman HOUGHTON. Well, look, I am sorry that time is running out and I really appreciate this. I think this is very, very, very important stuff and we are only going to begin this process now. If we can get this thing through, we can do other things which are important in terms of trying to narrow this gap between the very, very top-paid individuals and the people who are down the line.

So, thanks so much.

[Whereupon, at 11:28 a.m., the hearing was adjourned.]

[A submission for the record follows:]

AMAZON.COM, INC.
SEATTLE, WASHINGTON 98108-1226
October 18, 2000

The Honorable Amo Houghton
Chairman, Subcommittee on Oversight of the
Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

1Re: Hearing on Employee Stock Option Plans

Dear Chairman Houghton:

We appreciate the opportunity to comment on proposed changes in the Federal tax treatment of employee stock option plans. In short, Amazon.com would strongly support any proposals that would encourage widespread employee stock ownership and promote vigorous competition by innovative new enterprises.

Amazon.com must attract, retain, and motivate the most talented and versatile employees if it is to succeed in its drive to become the earth's most customer-centric

merchandiser. It offers its employees an opportunity for challenge, growth, and hard work in an exciting and rewarding environment as part of a team of unusually talented individuals.

The intensely competitive nature of Amazon.com's business, its emphasis on rapid growth, and the demands of a global Internet business require that employees make a serious commitment of time and energy to it. Amazon.com believes that all full-time employees should be "owners" of the business, in order to align incentives, encourage responsible and owner-like commitment, and to ensure that any rewards that result from building stockholder value are shared throughout the company. It is committed to the philosophy of employee ownership and to fostering a work environment grounded in mutual respect. Accordingly, all regular full-time employees of Amazon.com currently receive stock options upon their hire.

While Amazon.com offers both qualified and nonqualified stock options, the majority of the options issued are nonqualified, because of the Federal income tax limitations placed on qualified options. Under Amazon.com's stock option plan, an employee receives stock options on his employment start date. The options vest, or become exercisable, over 5 years and are generally exercisable over 10 years, provided that the employee remains an employee of Amazon.com during such time.

The price of the option is determined on the employee's start date and is equal to the fair market of the stock at that date. The fair market value is the average of the high and low price at which the stock was traded on the NASDAQ exchange on the employee's start date.

Once an employee's options vest, the employee may exercise his options and acquire Amazon.com stock at the exercise price provided in the option. If the options at issue are nonqualified stock options, the employee recognizes compensation income upon exercise. If the options are qualified options, and there is no disqualifying disposition, the employee recognizes no income upon exercise of the option. In either case, on the exercise date, the employee has received no cash. Thus, in order to pay the tax assessed at the exercise date for nonqualified options, an employee must sell some of his Amazon.com stock or take out a loan. A similar result occurs with respect to the alternative minimum tax on qualified options.

As noted above, Amazon.com relies on its stock option plans to attract, reward, and retain employees in a very tight labor market. Additionally, cash is always at a premium for a start-up company. Absent the ability to offer equity-based compensation, Amazon.com could not compete with established companies in cash-rich industries for the premier talent necessary to help it achieve its overall business goals. The barriers to entry for a company in an Internet environment are low, resulting in significant competition for scarce resources. The lure of the upside equity potential has been the single most effective tool enabling Amazon.com to attract experienced financial and technical personnel to work in the dynamic and fast-paced environment in which it operates. Moreover, the employees are truly owners, and their compensation is tied to the success of the company. Employees accept less cash compensation than they could get elsewhere, in return for the opportunity to share in the future success of the company through stock options.

Of course, the fact that Amazon.com is allowed a Federal income tax deduction with respect to the exercise of nonqualified options may one day help us to minimize cash expenditures, in the form of income tax payments. This deduction, however, is not a tax subsidy, in that it accurately reflects the employer's net income under Federal income tax principles. In other words, the employer is compensating its employees by carving out and granting them a portion of its equity. It could achieve the same economic effect by selling its shares and using the cash proceeds to compensate its employees. In that economically indistinguishable case, no one would deny that a compensation deduction was warranted.

We appreciate this opportunity to express our support for changes in the Federal income tax law that will encourage employee stock ownership and facilitate a long-term ownership commitment on the part of both employers and employees.

Sincerely,

ROBERT D. COMFORT
Vice President of Tax and Tax Policy

